MID-CAP VALUE

MARKET COMMENTARY

The Russell Midcap Index declined -5.7% in the first quarter of 2022. The Russell Midcap Value Index declined a more modest -1.8% while the Russell Midcap Growth Index declined -12.6%. Despite value's recent outperformance, the valuation spread between growth and value remains wide because the spread at the period's outset was extreme. The Russell Midcap Value Index trades at 15x forward P/E (consensus FY1) compared to the Russell Midcap Growth Index at 31x. This equates to a gap of 16x, which is much wider than the historical median of 7x dating back to the beginning of 2000.

The Consumer Price Index reached 7.9% year-over-year, its highest level in 40 years, raising the threat of tightening monetary policy. Russia's invasion of Ukraine continued to fuel worries over inflation. Sanctions and trade disruption created supply shocks, putting inflationary pressures on significant Russian exports like oil, natural gas, and metals—each experienced meaningful price increases in the period. WTI crude oil increased by 33%, finishing the quarter at $100/barrel; natural gas rose +51%, finishing the quarter at $5.64/MMBtu. Our view has been that the lack of investment in new energy projects/production would create an imbalance once demand recovered to pre-pandemic levels; the resulting supply shortage would put upward pressure on energy prices. While this continues to be our view, Russia's invasion of Ukraine has exacerbated the situation. Russia is the world's 11th largest economy, representing just 2% of global GDP. It is the world's largest exporter of natural gas; however, and the third largest exporter of crude oil. Russia provides more than 40% of Europe's natural gas and more than 25% of its oil. The rise in energy prices has increased energy companies' cash flows significantly. Many have used the cash to pay down debt, de-risking the sector extensively. Share repurchases have been another popular use of capital, which is accretive to shareholders because valuations remain compelling. M&A activity has also increased, which can also be positive for shareholders in the right situation, e.g., paying a good price, removing redundant costs. Each company is in a different situation but there are numerous opportunities for management teams to benefit shareholders. Consequently, energy remains a significant sector overweight in the portfolio notwithstanding the strong recent performance.

The number of job openings continues to hover around its highest level in at least 20 years, increasing the risk of further wage inflation. To combat these inflationary threats, the FOMC increased the Fed Funds rate by 0.25% and signaled more aggressive rate increases in the coming year. Higher interest rates are generally bad for equities because it increases the cost of capital and makes fixed income investments a more appealing alternative. It is typically less bad for value than growth for two primary reasons. First, financials represent the lone sector that benefits from rising rates (higher earnings), and financials comprise significantly larger portions of value portfolios/indexes. Second, value equities are shorter duration securities than growth equities. In a discounted cash flow analysis, the terminal value estimate represents the lion's share of a conventional growth stock's value, whereas a conventional value stock will generate meaningful cash flows sooner. Our portfolio continues to trade at a discount relative to the index on both a forward and normal P/E basis. We believe the large valuation spreads and macroeconomic backdrop should continue to benefit value relative to growth, which should be a conducive environment for our investment approach.

ATTRIBUTION – 1Q22

The Hotchkis & Wiley Mid-Cap Value portfolio (gross and net of management fees) outperformed the Russell Midcap Value Index in the first quarter of 2022 by a considerable margin. The overweight and stock selection in energy was the largest positive contributor, by far. The portfolio's energy positions returned +55% as a group compared to the Russell Midcap Value's energy return of +41%. Positive stock selection in industrials, communication services, and technology also helped. The underweight and stock selection in consumer staples detracted from relative performance, along with the underweight position in materials. The largest positive contributors to relative performance in the quarter were Kosmos Energy, APA Corp., Fluor, NexTier Oilfield Solutions, and Marathon Oil; the largest detractors were Royal Mail, First Citizens, Goodyear Tire, Adient, and Whirlpool.

LARGEST NEW PURCHASES – 1Q22

AMERCO (UHAL), the parent company of U-Haul, is the dominant DIY (do-it-yourself) moving company, with almost 22k locations in the US and Canada. Their superior operating results come from one-way moves where a truck is rented at one location and dropped off at another. This model is extremely difficult to replicate and is highly costly – giving UHAL the first mover advantage. Their larger network and reservation system allows the company to properly price one-way moves given the location advantage, truck utilization, and cost to return the trucks. As a result of these advantages, UHAL offers a better price, value, and cost when compared to competitors; in fact, UHAL is 10x larger than the next competitor. We initially exited our position near the end of 2021. Price performance had appreciated 60% in FY2021, and more than 100% since Q4 2020. Since the beginning of 2022, UHAL has fallen almost 15% in just a few weeks – offering a worthwhile buying opportunity for a high-quality business that was formerly one of the top performers in our portfolios.

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Brink's is the largest cash management and secure logistics company in the world. The company is the #1 or #2 cash in transit operator in its major markets. Approximately 1/3 of normal revenue is from North America, about 1/4 from Latin America, another 1/4 from the EU, and the remainder is spread around the rest of the world. Their valuation is attractive assuming their guidance is accurate – and could be even more attractive if their new products expand the addressable market as we believe may be possible.

Murphy Oil (MUR) is an oil and gas company that primarily operates in the US and Canada. We continue to see much promise in the energy industry as supply has not kept up with demand. MUR trades at a low multiple to normal earnings, which does not account for the potential of their exploration operations in Brazil. Finally, if commodity prices increase, normal EPS could have an even more substantial upside.

Composite performance is available at www.hwcm.com, located on the strategy's Performance tab. Returns discussed can differ from actual portfolio returns due to data differences, cash flows, trading, and other activity. Portfolio characteristics and attribution based on representative Mid-Cap Value portfolio. Certain client portfolio(s) may or may not hold the securities discussed due to each account's guideline restrictions, cash flow, tax and other relevant considerations. Performance attribution is an analysis of the portfolio's return relative to the index, is calculated using daily holdings information and does not reflect management fees and other transaction costs and expenses. For the portfolio's total performance attribution, interaction effect is combined with stock selection. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the index. Other securities may have been the best and worst performers on an absolute basis.

The value discipline used in managing accounts in the Mid-Cap Value strategy may prevent or limit investment in major stocks in the Russell Midcap, Russell Midcap Value and Russell Midcap Growth and returns may not be correlated to the indexes. Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy's Portfolio and Literature tabs. For a list showing every holding's contribution to the overall account's performance and portfolio activity for a given time period, contact H&W at hotchkisandwiley@hwcm.com. Portfolio information is subject to the firm's portfolio holdings disclosure policy.

Equity securities may have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in small and medium-sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity.

The "Largest New Purchases" section includes the three largest new security positions during the quarter/year based on the security's quarter/year-end weight adjusted for its relative return contribution; does not include any security received as a result of a corporate action. If fewer than three new security positions during the quarter/year, all new security positions are included. Securities identified do not represent all of the securities purchased or sold for advisory clients and are not indicative of current or future holdings or trading activity. H&W has no obligation to disclose purchases or sales of the securities. The largest new purchases are as of the publication date but may be sold and no longer held in the Mid-Cap Value strategy at any time, for any reason, without notice, subsequent to the publication date. The securities reflected herein are intended to be for illustrative purposes only and are not intended to be, and should not be construed as, investment recommendations or investment advice. Past performance of these securities, or any other investments, is not an indicator of future results. H&W's opinions regarding these securities are subject to change at any time, for any reason, without notice. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable.

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Market Disruption: The global coronavirus pandemic has caused disruption in the global economy and extreme fluctuations in global capital and financial markets. H&W is unable to predict the impact caused by coronavirus pandemic, which has the potential to negatively impact the firm's investment strategies and investment opportunities.

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